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11 March 1982

MEMORANDUM FOR: Maurice Ernst
NIO/Economics

FROM

:

[REDACTED]
SOVA/SE/R

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SUBJECT

:

1984 Floor Price of Soviet Natural Gas
Exports

1. The attached packet of classified and unclassified documents traces the evolution and acceptance of the floor price concept by all parties in the Soviet-West European pipeline negotiations of late 1981 and early 1982. While there are some discrepancies in reporting on the exact amount of the floor prices in the West European contracts (in part in the West German case because the contract reportedly is denominated in DM and exchange rate assumptions affect the US dollar representation of the price), the attached documents establish the existence of the "floors" (see especially references marked in red as (2), (5), (6), and (7)).

2. There is no question that Soviet gas could be hard to sell at \$5.40/MMBTU's in 1984-1986, if the price of crude and fuel oil remains soft. On the other hand, gas prices above the floor can be negotiated each year. Soviet insertion of the floor price was essential to protect their flanks during the eight year amortization period. Soviet linepipe orders (for the export line and domestic lines) over the next four years will be subject to rising "concessionary" interest rates and higher prices. The gap between the FRG concessionary and market rates (7.75 vs. 12.0) in 1981 was added to the price of the pipe. Construction delays will also cause project costs to rise due to inflation and added interest charges. Therefore, the Soviets insisted on the floor price to ensure repayment of the future pipe credits as well as the pipeline loans. In return, Ruhrgas and Gaz de France got the indexation formula to guarantee a competitive price for gas over the

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long run. One can argue that negotiators on both sides viewed the present oil glut and soft market conditions as a temporary aberration and that oil prices would firm up by 1985.

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Resources Branch
Soviet Economy Division
Office of Soviet Analysis

Attachments:

- 1 - EE Markets Financial Times,
16 Nov 81 article

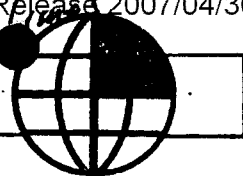
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FOREIGN TRADE



Soviet gas exports forecast cut

Anticipated Soviet gas exports to the European Economic Community of some 60-63bn cu.m from 1985 onwards may not actually be realised if revised estimates on future gas consumption from the EEC Commission prove to be correct.

Last year the EEC countries imported 26 per cent of their natural gas consumption from non-EEC sources. Norway was the main supplier accounting for 52 of the imports and the USSR was a close second with 40 per cent. For exceptional reasons the EEC's other main supplier, Algeria, supplied only 6 per cent.

It was estimated that by 1985 gas imports would rise to 110bn cu.m with the bulk of the increase coming from the USSR via the proposed gas pipeline from Urengoi in the Tyumen region of north-west Siberia (code named *Russia No. 6*). By 1990, it was estimated, imports from non-EEC sources would rise to 152-157bn cu.m.

But this estimate has now been substantially cut to 91bn cu.m by 1985 and 135bn cu.m by 1990. Moreover, it would appear that it will be supplies from the Soviet Union which will bear the brunt of the decrease.

Last year the USSR exported 21.7bn cu.m of gas to the EEC as follows:

West Germany	10.7bn cu.m
France	4.0 "
Italy	7.0 "

In addition, Austria, a non-EEC member imported 2.5bn cu.m of Soviet gas.

Under the original estimates this was to be increased by the following additional imports via *Russia No. 6*:

West Germany	12bn cu.m/year	11.25
France	8-10bn cu.m/year	7.8
Italy	10 "	6.0-8.0
Netherlands	5 "	
Belgium	5 "	

Non-EEC

Austria	3 "
Switzerland	1 "

On this basis the EEC would be importing an additional 40-42bn cu.m to bring total imports from the USSR up to a 63.7bn cu.m. As for western European imports as a whole, these would rise from the current 24.2bn cu.m to 68-70.2bn cu.m.

According to the EEC commission, this would have raised the share of Soviet gas in EEC gas consumption to 22 per cent and in total EEC primary energy consumption to 4 per cent. But in the case of West Germany it would raise its dependence on Soviet gas to 34 per cent of its total supplies by 1990 instead of 16 per cent; France to 26 instead of 9 per cent and Italy to 35 instead of 15. Belgium and Holland, which currently do not receive Soviet gas, would depend on Soviet supplies for 38 and 11 per cent of their total gas supplies. The current dependence of the EEC as a whole is 7 per cent.

As a comparison, the EEC is likely to rely on Algeria for 9 per cent of its gas supplies in 1990 and on Norway for 10

per cent. Algeria and Norway are expected to represent 21 and 14 per cent in the case of West Germany, 20 and 6 for France, 26 and zero for Italy, 13 and 7 for Holland, 38 and 22 for Belgium and 2 and 14 for the UK.

By concluding an agreement with the Soviet Union, France would find itself 83 per cent dependent on non-EEC supplies in 1991 compared to 30 per cent last year, Italy for 68 per cent compared to 28 per cent, Belgium for 56 per cent compared to 21 per cent and West Germany for 48 per cent compared to 34 per cent.

Thus the USSR would become the EEC's most important external source at a time when the Community would be relying on imports for 46 per cent of its supplies instead of only 26 per cent last year.

But a number of factors have combined to reduce these estimates. Success in the introduction of energy saving measures into industry combined with the effects of the general recession on energy consumption have jointly reduced projected gas demand.

Equally important, however, is the price reportedly sought by the USSR for the gas in its negotiations with Ruhrgas AG, in West Germany, Gas de France and ENI of Italy, the main purchasers. Apparently the USSR has been seeking a January 1, 1981 price of \$5.5 per million btu compared with a west European offer of \$4.40. The USSR is also seeking a price floor when deliveries start in 1984 regardless of what the indexation would produce.

As a result of these developments, deliveries via *Russia No. 6* are now likely to be reduced as follows:

West Germany	10-12bn cu.m/year
France	7.8 6-8 "
Italy	6-8 "
Netherlands	3 "
Belgium	3 "

to produce a total of 30-34bn. cu.m excluding the 4bn cu.m/year sales to Austria and Switzerland.

The result of this reduction would substantially cut the EEC's dependence of Soviet supplies, at least temporarily. In the long term, however, there does not seem to be any truly viable alternative. The Commission observes that out of total world reserves of 74,721bn cu.m, no less than 26,050bn are within the Soviet Union. Iran has 13,730bn, but the EEC's other main suppliers, Algeria and Norway, have reserves of only 3,720 and 1,210bn cu.m respectively.

But even a temporary cut-back could have serious results for the USSR. Increased gas exports to western Europe of some 50bn cu.m a year from 1985 on are a fundamental part of the country's development plans. *Russia No. 6* itself is an integral part of the Soviet Union's development plans for its internal gas exploitation and distribution system, and the hard currency earnings from the increased gas exports are needed to compensate for an anticipated fall off in oil export earnings from the mid 1980's.

In 1979 Soviet natural gas exports to Western Europe provided about 11 per cent of its total export earnings from the industrialised West, whilst exports of other fuels (oil, coal, electricity etc) amounted to some 58 per cent. Current Soviet plans are based on increasing gas export earnings to about 35-40 per cent of total export earnings by 1990 to compensate for a fall in export earnings of other fuels to some 35-40 per cent. The estimated 19bn

Floor price

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